

APPENDIX

Notes for FOMC Meeting

December 18-19, 1980

Scott E. Pardee

During most of the period since the November 18 meeting, the dollar continued to be in demand against most major currencies. The further rise of U.S. interest rates, particularly as translated through the Euro-markets, was universally cited as the major reason for the dollar's strength. Other factors--concern over the possibility of Soviet military action in Poland, the latest hike in the OPEC oil price, and the general outlook for the current account balances--all influenced traders from time to time, but the pressure of U.S. interest rates has dominated market sentiment. Our impression is that although substantial amounts of funds have moved into dollars, the volumes have not been as massive as in other instances in which dollar rates have been bid up. Indeed, we have heard isolated reports of U.S. corporate treasurers who were borrowing dollars abroad rather than selling foreign currencies to make year-end repatriations on the expectation that the dollar will decline again in the exchange market. And several OPEC central banks have been known to take advantage of the rather depressed exchange rates for other currencies to shift funds out of dollars. Also, the market has been thin, which has led to some backing and filling, as usually happens toward year-end. There is a strong impression that once U.S. interest rates finally do peak out, the dollar will fall back in the exchange market. The dollar has settled back over recent days even though the direction of U.S. interest rates is still in doubt. On balance the dollar has advanced by 4 percent against the German mark and other EMS currencies, 3 percent against the pound sterling, and has declined 1-½ percent against the Japanese yen.

The U.S. dollar also advanced by 1-½ percent against the Canadian dollar. The Canadians were hit particularly hard by the surge in U.S. [unintelligible] in a situation in which their reserves were already depleted. They raised with us the possibility of drawing on the swap line for bridge financing while they arranged for takedowns on their standing credit facilities with Canadian and other banks. After consultation with the FOMC Subcommittee and the Treasury, I have told them that we would agree to a drawing of up to \$300 million. In other intervention, we have continued to pile up marks, perhaps not so vigorously as before now that the Treasury is fully covered under the Carter notes, and the Federal Reserve wanted

to review its own situation. We bought a total of \$2.0 billion, of which \$340 million was put into System balances. These now amount to \$1,433 million equivalent. The remaining marks went to the Treasury, which now has \$300 to \$500 million in excess of its needs under the Carter notes. Yesterday, when the dollar dropped off sharply in thin trading we sold a net of \$41 million of marks out of System and Treasury trading balances using two-way prices to settle the market.

James L. Kichline
December 18, 1980

FOMC BRIEFING

Incoming evidence on economic activity generally has continued upbeat in recent weeks, and it is clear the economy developed a good deal of momentum this quarter. Our assessment of available information has led us to raise the projection of real GNP growth in the current quarter to $4\frac{1}{2}$ percent at an annual rate. But the recent pace of activity appears to be unsustainable, and we continue to believe fundamental forces affecting activity--including monetary and fiscal policy--dictate a slowdown in the near term and a sluggish economy over the forecast horizon.

Labor demands have continued to strengthen in recent months while the unemployment rate has remained in the neighborhood of $7\frac{1}{2}$ percent. In November, nonfarm employment rose $\frac{1}{4}$ million, bringing the total rise in payroll employment to 1 million above the trough in July. In addition, the average length of the workweek increased a bit further last month. Even if one assumes no expansion in December, total labor hours will increase at an annual rate of $6\frac{1}{2}$ percent this quarter. A good deal of the growth in hours has been in the manufacturing sector, where many workers have been recalled from layoff.

The strength of the labor market in recent months has been associated with sizable increases in industrial production. In November the industrial production index rose nearly $1\frac{1}{2}$ percent, and output was revised up for the preceding two months. Output gains recently have been fairly widespread, with continued very large increases in production of steel and other durable materials

as well as construction products.

For a while it appeared that a substantial inventory imbalance was in the making, given rapid growth in output and reported weakness in final sales. Although we still anticipate some buildup in inventories this quarter, following liquidation last quarter, the size of the near-term problem has been limited by the reported strength of final sales. In the retail sector, sales figures were revised up considerably for October and the advance data for November indicate further expansion. However, the anecdotal evidence on retail sales since November, in the Redbook and elsewhere, is mixed but generally suggestive of sluggish sales; our forecast implies a slowing of sales this month and on into early 1981. Should consumers finally behave as predicted, a prompt cutback in output growth will be needed to avoid a larger inventory adjustment than in the current forecast.

The auto sector already is on this course, cutting production in response to disappointing sales. Domestic auto sales have moved within a range of $6\frac{1}{2}$ to 7 million units at an annual rate from July through the first third of December. The much heralded introduction of new, more fuel-efficient models obviously has not solved the overall problems of the industry. Auto assembly schedules have been reduced in recent weeks and for December are currently planned to drop 10 percent from those in November. Although rebate programs at Ford and Chrysler may help to hold up sales in the very short run, it still seems likely that sales will move down a little early next year under the pressure of tight financial conditions and declining real disposable incomes.

Housing activity also appears to be on the verge of a drop, but one could not detect that in the figures for November. Starts were surprisingly strong at somewhat over a $1\frac{1}{2}$ million unit annual rate, the same pace that has prevailed since September, and permits increased slightly. Perhaps the market has performed better than generally anticipated for a variety of reasons, including good weather, the growing use of creative financing techniques, and less resistance to high interest rates that had a rather prompt, visible effect the first time around. Nevertheless, it is difficult to conceive that the mass of qualitative evidence pointing to a sharp decline is wrong in the face of construction loan rates above 20 percent and permanent financing rates that are averaging nearly 15 percent nationwide. In the forecast, housing starts drop to a little over a million units early next year and remain there through 1982, reflecting continued tight financial market conditions and weak growth of incomes. If interest rates were to move lower than now expected, housing would surely strengthen, particularly in light of the demographic factors and pent-up demands.

For the business sector, information on shipments of capital goods, truck sales, and nonresidential construction activity point to a further decline in fixed investment in real terms this quarter. Exceptionally strong activity in the petroleum sector has helped limit the drop in capital outlays this year and should continue to do so next year as well. But the evidence on orders and contracts generally suggests a weak investment sector going into 1981. Moreover, a slackening of final sales and the continued

high cost of capital seem likely to increase business caution in making longer-term commitments.

The downturn in economic activity that is projected for the first half of next year could well coincide with a deterioration in price statistics, especially this winter. Energy prices are projected to rise rapidly early next year, as producers take the opportunity to pass through higher costs of imported and domestic petroleum products at a time when large stocks will probably have been worked down. Food prices, particularly meats, are also projected to continue rising faster than the average rate of inflation in light of tight supplies and rising input costs. Upward pressure on prices next year also will come from the payroll tax increase beginning January, which is estimated to raise inflation about $\frac{1}{2}$ percentage point from what it would otherwise be in 1981. Underlying these factors, moreover, is the projected large further rise of unit labor costs next year. By 1982, however, the forecast shows visible progress in reducing the rate of inflation, a reflection of the impact of persistent slack in labor and product markets as well as the beneficial expectational impacts of consistent anti-inflationary policies.

On the policy side, both monetary and fiscal policy assumed in the forecast act to restrain growth of nominal GNP. For monetary policy, strong nominal transactions demands are thought to entail high nominal interest rates throughout the forecast period if specified growth rates of the monetary aggregates are to be achieved. For fiscal policy, the high employment budget

surplus continues to rise even with a \$35 billion tax reduction assumed for next year. But the actual budget totals simply look awful, a \$60 billion deficit in fiscal 1981 and over \$75 billion in 1982. In large part this is a reflection of an economy operating well below potential. In addition, it reflects the great difficulty in cutting quickly and deeply into growth of nondefense outlays.

The blue book provides the Committee with a basis for judging the economic implications of various alternative money targets and strategies. The approach labeled strategy 1 involves the same 1/2 percent point reduction in 1981 of target ranges for the M-1's that was tentatively agreed to by the Committee in July. That approach is consistent of course with an effort gradually to reduce money growth over time as a means of promoting price stability. But, as it turns out, all of the other alternative 1981 growth rates for the M-1's shown in the blue book could also be interpreted as being consistent with a policy of gradually reducing money growth. That is possible because all of them would involve lower M-1 growth than in 1980, abstracting from the impact of deposit shifts into newly introduced interest-bearing checking accounts (called OCD's). In 1980, the actual growth rate of M-1A, for example, will be around $5\frac{1}{2}$ percent, but the growth abstracting from deposit shifts into OCD's is estimated at $6\frac{1}{2}$ to $6\frac{3}{4}$ percent. The various M-1A assumptions on a comparable basis for 1981 employed in the blue book ranged between $3\frac{1}{2}$ and 6 percent.

Thus, in deciding on its longer-run target for 1981 the Committee would probably want to consider whether to take off from the effective growth attained for, say, M-1A in 1980--that is after adding back deposit shifts--or from targeted growth. If the FOMC were to reduce effective growth by $\frac{1}{2}$ point next year, that would imply growth of about 6 percent. If it were to reduce targeted growth, that would imply growth in a range with a midpoint of $4\frac{1}{2}$ percent, as tentatively decided in July. Our quarterly econometric model would not suggest any substantially different price effects next year from such a difference in money growth rates--the effects come later. Price expectations change slowly in the model and are based

solely on past price behavior; thus, the model would not allow for any decline of inflationary expectations based on Fed monetary targeting decisions or other of what might be termed exogenous events.

The Committee may therefore wish to consider the likely impact on inflationary psychology from announcement of longer-term targets. If the Committee were to indicate that the effective growth of M-1A in 1980 was really $6\frac{1}{2}$ to $6\frac{3}{4}$ percent and that growth in 1981 would be brought down from there to a range centering on a rate $1/2$ point lower, under current circumstances--with price increases perhaps accelerating early next year when the targets will be announced and restraint on the Federal budget uncertain--inflationary psychology might be adversely affected. To the extent that such a monetary approach could be understood by the public, they might well conclude that the Fed had created even more money than earlier thought and would be doing the same next year. Of course, it should be pointed out that we have little evidence about how the public reacts to announced targets, and the Fed would be able to condition reactions to an extent through its explanation of the chosen target.

However that may be, if next year's growth target represented a reduction from the current target range, rather than from growth actually achieved, there would be virtually no risk of exacerbating inflationary psychology from announcement of the targets. And also probably virtually no risk of doing so if this year's targets were retained, instead of reduced. But in either case there would also seem to be little room, if any, for an expansion of real GNP over 1981, unless there were a rather startling and rather prompt improvement in attitudes toward inflation (or a reduction in upward price pressures stemming from a near miraculous rebound in productivity).

In considering M-1A, and also M-1B ranges, the Committee would also need to take account of the probability that M-1 targets will or will not be consistent with what the Committee takes to be a tolerable, if not satisfactory, increase in nominal GNP over the year. The tentative monetary targets already set for next year can be viewed as quite restrictive relative to a 9 or 10 percent rise in nominal GNP. For instance, they would imply a larger downward shift in demand for M-1A, after allowing for whatever shift will be due to NOW accounts, than took place last year. There are good reasons for that: large downward shifts have occurred in recent years following new, unusually high interest rate peaks--witness the years 1975, 1976 and the second quarter of 1980--and shifts can be particularly large when these peak rate levels occur at a time when new financial technology is in any event causing the public to reconsider cash balance needs (as will be the case next year). On the other hand, it should be pointed out that there has already been very extensive economization of cash balances since the mid-70's, and the question can legitimately be raised as to whether there is any significant amount of cash left to be economized, apart from the transfers out of demand deposits expected as a result of nationwide NOW accounts.

I should mention a problem that needs to be considered with respect to the broader aggregates. It would appear that nominal GNP growth of 9 percent or so next year would entail some increase in the total of funds raised in financial markets--currently, we estimate a conservative increase of a little over 5 percent. Even assuming that the share of total credit advanced by banks and thrift institutions together declines a bit, if depository institutions are to meet the projected credit demands, it would appear that growth in M-2 next year may well need to exceed the

upper limit of the 1981 range for that aggregate tentatively set by the FOMC at mid-year and that growth in M-3 would be near the upper end of its range.

So far in this review of issues involved in next year's monetary targets I have not mentioned the difficult problem of public understanding of the behavior of M-1A and M-1B in light of deposit shifts into new NOW accounts. In setting its 1981 targets for M-1A and M-1B in February the Committee if it follows past practice would adjust the target ranges to reflect the estimated distorting effects of such deposit shifts. The blue book appendix on the subject contains a wide range of estimates that center on a 4 percentage point reduction in M-1A and a 2 percentage point increase in M-1B. If the public focuses on M-1B growth, and ignores the low M-1A, the upward adjustment in the M-1B range, and presumably the accompanying relatively high actual growth, could be given--erroneously--an inflationary interpretation. The interpretation may be more likely to arise in the degree that actual M-1B growth comes in above target, as it could if we have underestimated the likely shift out of savings deposits into NOW accounts--as is certainly possible, partly because the differential between yields on NOW and ordinary savings accounts at banks will disappear at the beginning of the year.

One implication for monetary targeting from these various uncertainties is to widen the ranges for M-1A and M-1B from their present $2\frac{1}{2}$ percentage point width, explaining that is necessary to allow for the uncertainties about deposit shifts. Another approach would be to specify target ranges in terms of effective growth in M-1's abstracting from deposit shifts, instead of actual growth. This approach has certain

disadvantages, however. If the public is to be able to track behavior of the M-1's relative to such a target, the System would have to publish regularly estimates of deposit shifts into NOW and related accounts by source, so that the public could make adjustments to translate actual growth into effective growth on a current basis. But publication of, for example, weekly estimates of such shifts would be pretending to more certainty than we have, may be confusing, and would probably also entail showing the higher growth rates for M-1A in effective terms in 1979 and 1980 for comparative purposes.

Of course, some data on deposit shifts will be needed next year however the Committee decides to present its M-1 targets. Thus, the staff will in any event be seeking additional information. We are proposing to ask a sample of banks and probably other depository institutions from time to time to estimate sources of funds flowing into new NOW and related accounts. That data will be needed internally to help determine if the assumptions about deposit shifts that lie behind actual monetary growth targets--both short- and long-term ones--need to be modified.

In brief summary of what seems to me to be a difficult decision for the Committee, there are strong arguments for widening the ranges for the M-1's. This would be an indirect way of downplaying their importance in the period ahead, but would have the disadvantage of seeming to loosen monetary discipline. On whether the central tendency of the ranges for effective growth in the M-1's in 1981 set in July should be retained, raised, or lowered, the decision would appear to depend strongly on how much pressure the Committee considers feasible to place on the economy relative to the apparent sizable built-in upward price pressures and how the Committee assesses likely public response to its announced targets. Finally, on the

broader aggregates, there seems to be a good chance that the lower range set in July for M-2 may be too low for practical purposes, as indeed even may be a range for 1981 unchanged from 1980. The Committee would need to weigh whether the loss in credibility from raising the range at this point is greater than the risk to credibility of a probable overshoot of the range next year.

REPORT OF OPEN
MARKET OPERATIONS

Reporting on open market operations, Mr. Sternlight made the following statement.

The financial markets have come through considerable turbulence in the period since the November FOMC meeting--but it's possible that an experience of this kind will prove helpful in the process of taming the monetary aggregates. Not that I think all the turbulence is behind us or that money supply is assuredly under firm control now, but we've begun to get some real sense of the bite of monetary restraint in other areas besides housing and thrift institutions. It's becoming painfully expensive to hold inventories, whether of cars or commodities. There is even a glimmering of abatement in monetary growth, though it is surely premature for rejoicing over what could be a fine Christmas present indeed, if it came about.

The recent period began with dreary similarity to the preceding several months. Barely a few days after the last meeting it looked as though monetary growth was running substantially above desired path levels, and as the Desk pursued reserve targets associated with the slow desired pace, more pressure was placed on the banking system. Discount window borrowing was pushed higher and money rates surged upward. Restraint was reinforced about midway through the period when the nonborrowed reserve path was reduced by \$170 million, or by half of the then-anticipated bulge of total reserves above path. The December 5 discount rate and surcharge increases further accented the System's restraining posture. Whether

because of the recently increased restraint, or in lagged response to earlier restraint, one cannot say, but as the period progressed the bulge of projected reserve demands for the intermeeting period worked down to about \$200 million at last report, compared to \$300-400 million in the opening weeks.

In the earlier part of the period, given the large bulge in reserve demand above path, and then the deliberate reduction in the nonborrowed reserve path about midway in the interval, the Desk aimed for nonborrowed reserve levels such that borrowing was expected to be around \$1.9 to \$2 billion. More recently, as the overshoot in reserve demand abated, the expected borrowing level receded somewhat to the \$1.6 - \$1.7 billion area. Federal funds have stayed quite high, however, partly reflecting a momentum of market developments reinforced by the discount rate action about midway in the period.

Around the time of the last meeting, the funds rate had just surged to higher levels in the wake of the discount rate action announced November 14. Trading was somewhat above the 17 percent upper bound adopted at the November 18 meeting, although there was a widespread view both in the market and on the official side that the rate probably would tend to decline shortly as the market regained composure after the discount rate move. Any such tendency was offset, however, as the strengthening monetary aggregates led to greater needs for borrowings. Thus the average funds rate in the first full week after the last meeting rose over 2 percentage points to nearly 17 1/2 percent. Against that backdrop the Committee

raised its upper bound on funds to 18 percent and pursuit of reserve objectives in the next week led to an average rate around 17.70 percent. In the following week, the Board approved a further rise in the discount and surcharge rates, and once again there was an immediate upsurge in the funds trading rate--initially to about 20-21 percent. To permit operational flexibility to pursue the reserve targets, the Committee temporarily suspended the 18 percent funds ceiling--though with the understanding that operations were not to proceed in total disregard of where funds traded or the impact this might have on the markets more generally. The average rate in the December 10 week pushed up to about 18.80 percent, while in the December 17 week it was 19.83 percent. Yesterday was 20 3/4.

The Desk operated mainly through temporary reserve adjustments, as befitted a period marked by particular uncertainty in reserve estimates partly due to changed reporting procedures in the wake of implementation of the Monetary Control Act. There was also substantial uncertainty about desired levels of excess reserves. The recent high reported levels of excess reserves, though reduced somewhat by subsequent revisions, remain something of puzzle. And in case all this was not enough, a further complication was the reserve impact of the winding down of weekend Eurodollar reserve-saving games, which added to requirements during the period. In addition to its temporary transactions, the Desk provided for some permanent reserve additions, toward the end of the period, through the purchase of about \$900 million in Treasury

bills in the market, and some \$400 million in bills and \$100 million in coupon issues from foreign accounts.

The rise in rates since the last meeting was exceptionally sharp in the money market area, as banks came under pressure to meet reserve needs and fund present and anticipated loan increases. Bank CD rates rose by some 3 to 6 percentage points over the period, reaching about 21 percent for 3-month maturities before receding a bit near the end of the period. This was well above peak of about 18 1/2 percent for 3-month CD's last March. Commercial paper rates also scaled new heights, pushing close to 21 percent and rising a net of some 4 to 5 1/2 percentage points for the period. The bank prime rate rose 4 3/4 percentage points, reaching 21 percent, and Citibank moved to 21 1/2 percent this morning.

At the same time, Treasury bill rates rose by some 1 to 3 percentage points through mid-day yesterday, although some appreciable part of this has been reversed in the past 24 hours. At last Monday's auction, 3- and 6-month bills were sold at average rates of 16.67 and 15.42 percent, compared with 14.31 and 13.92 percent the day before the last meeting. The latest 3-month auction rate was a new record, while the 6-month was some 30 basis points under the record set last March. Latest market rates have come off those peaks. Based on the latest 6-month rate, banks and thrifts can pay as high as 15.67 percent for \$10,000 6-month certificates--a rate that substantially exceeds the thrifts' earnings rates.

Short-term coupon issues also showed sizable yield increases. The yields of intermediate-term Treasury issues were up a more moderate 100 basis points or so, while active long-term issues

showed little net change for the period. Early in the interval, long-term issues held their own pretty well, as there seemed to be a feeling that increased monetary restraint, while raising short rates, would depress the economy and encourage a return to price stability. As the period went on, and short rates pressed still higher while news on the economy still pointed to some areas of strength, the long end weakened, too; but in the last couple of days there has been a price recovery, partly based on anticipations of dramatic actions that the new Reagan Administration might take, and partly on anticipations of some weakening in money growth. During much of the period, the prospect of sizable Treasury deficit financing, as well as of monetary restraint, was a depressant in the Government market. The Treasury sold 2- and 4-year notes this week at yields of 15.15 and 14.03 percent, and the market now faces a 7-year issue to be auctioned December 30 and a 15- or 20-year issue early in the new year.

Despite the volatility of securities prices, the Treasury market functioned reasonably well. Activity was thin, but not obviously disorderly or panicky. Auctions have been amply covered. Government securities dealers have managed, so far as we are aware, to avoid serious losses, although there has been red ink for some.

In fact, amidst all the turbulence we even managed to add another name to the list of dealers trading with our Desk--Smith Barney, an old line name in investment banking, but only recently an active Government securities dealer.